

TITLE 10. CALIFORNIA DEPARTMENT OF CORPORATIONS

NOTICE OF PROPOSED CHANGES IN REGULATIONS

NOTICE IS HEREBY GIVEN

The Commissioner of Corporations ("Commissioner") proposes to adopt Rule 260.204.9 under the Corporate Securities Law of 1968 relating to an exemption from licensure for certain investment advisers with fewer than 15 clients.

PUBLIC COMMENTS

No public hearing is scheduled. Any interested person or his or her duly authorized representative may request, in writing, a public hearing pursuant to Section 11346.8(a) of the Government Code. The request for hearing must be received by the Department of Corporations' ("Department") contact person designated below no later than 15 days prior to the close of the written comment period.

WRITTEN COMMENT PERIOD

Any interested person, or his or her authorized representative, may submit written comments relevant to the proposed regulatory action to the Department of Corporations, addressed to Kathy Womack, Office of Policy, Department of Corporations, 1515 K Street, Suite 200, Sacramento, CA 95814-4052, no later than 5:00 p.m., Monday, April 30, 2001. Written comments may also be sent to Kathy Womack (1) via electronic mail at regulations@corp.ca.gov or (2) via fax (916) 322-5875.

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Under current law, the Department of Corporations regulates certain activities of "investment advisers" in California. Specifically, Corporations Code Section 25230 of the Corporate Securities Law of 1968 (the "CSL") requires persons conducting business as an investment adviser in California to be licensed with the Department of Corporations. Investment advisers licensed under the CSL are subject to various obligations and restrictions, as set forth in the CSL and the rules of the Commissioner.

The definition of "investment adviser" under Section 25009 includes, with certain exceptions, any person who "for compensation, engages in the business of advising others . . . as to the advisability of investing in, purchasing or selling securities" This definition arguably encompasses the general partner or manager (a "GP") of those pooled investment vehicles that are commonly referred to as "venture capital funds" or "venture capital companies" ("VCCs"). These pooled investment vehicles, which historically have been organized as limited partnerships (and, more recently, as limited liability companies), raise funds from multiple investors and use the funds to invest in (or acquire) start-up, operating companies. In the typical VCC, the GP has the sole authority to make investment decisions; the limited partners of the VCC are generally required to fund their capital contributions when and as requested by the GP, and are not permitted to make an investment decision with respect to any particular portfolio investment by the VCC (subject to certain excuse or withdrawal rights in limited circumstances).

Over the last 20-30 years, VCCs have played an increasingly significant role in the establishment and growth of start-up companies in California, particularly technology-based companies.

A substantial number of VCCs, including many of the largest, oldest and most recognized VCCs, are based in California.

In 1971, the Department issued Policy Letter No. 151 (the "1971 Letter") indicating that a GP of a single limited partnership would not have to be licensed as an "investment adviser" under the CSL. The basis of the 1971 letter was the Department's view that a GP is, in effect, giving advice to itself rather than to "others" as required under Section 25009 of the CSL. The 1971 Letter had generally been relied on by California-based GPs of VCCs seeking an exemption from licensing in California as an investment adviser.

In April 1998, the Department issued Release No. 110-C (the "1998 Release"), which essentially revoked the 1971 Letter. In the 1998 Release, the Department indicated that the position taken in the 1971 Letter was contrary to the treatment of investment advisers by the Securities and Exchange Commission (the "SEC") under the Investment Advisers Act of 1940 (the "Federal Advisers Act"). Under the Federal Advisers Act, general partners of limited partnerships are treated as advising others, although GPs that advise fewer than 15 VCCs are typically exempt from registration under Section 203(b)(3) of the Federal Advisers Act and certain rules of the SEC thereunder that are specifically tailored to VCCs (the "SEC Safe Harbor Rules").

As a result of the Department's issuance of the 1998 Release, there is no specific licensing exemption for California-based GPs of VCCs (or any other limited partnerships) similar to the Federal Advisers Act exemption. However, there is an exemption from licensing that can be relied upon by GPs based outside of California. Specifically, Section 25202(a) of the CSL provides that the licensing requirement of Section 25230 shall not apply if:

"(1) the investment adviser does not have a place of business in this state and (2) during the preceding 12-month period has had fewer than six clients who are resident in this state."

Section 25202(b) of the CSL further provides, essentially, that for purposes of "counting" the number of clients for the fewer-than-six client test of Section 25202(a)(2), an investment adviser may rely on the SEC Safe Harbor Rules. Thus, while the critical elements of the SEC Safe Harbor Rule currently exist under the CSL exemption with respect to GPs based outside of California, these elements do not apply to California-based GPs.

Proposed Rule 260.204.9 reflects the Commissioner's view that, in light of the nature and structure of VCCs, requiring the GPs of VCCs to be licensed in California as "investment advisers" would be unnecessary and unduly burdensome. More importantly, because Section 25202(a) of the CSL generally excludes from licensing in California any GP who does not have a place of business in California and has fewer than six clients who are California residents), requiring a California-based GP to be licensed as an investment adviser under the CSL could encourage such GP to relocate from California to a state that does not require such licensing or that imposes less onerous obligations on registered investment advisers.

Subsection (a) of the proposed rule would exempt from licensing as an investment adviser any person who:

1. Does not hold itself out generally to the public as an investment adviser;

2. Has fewer than 15 "clients";
3. Is exempt from registration under the Federal Advisers Act by virtue of Section 203(b)(3) thereof; and
4. Either (i) has "assets under management" of not less than \$25 million or (ii) provides investment advice to only "venture capital companies."

Subsection (b) of the proposed rule sets forth definitions of the terms used in the operative provisions of Subsection (a), including a definition of "venture capital company." This definition imposes, as a requirement, the typical investment activity of a VCC. Specifically, under the proposed rule an entity will be considered a "venture capital company" only if it invests a majority of its assets in operating companies and acquires "management rights" in those companies. Historically the management rights acquired by VCCs in connection with their investment in operating companies have included one or more of the following: veto or approval rights as to certain operational or structural matters; inspection or information right; or board membership or observer rights.

The exclusion for VCCs with more than \$25 million reflects the current allocation of investment adviser regulation between the SEC and state securities administrators. Under applicable federal law, (i) investment advisers with at least \$25 million in assets under management are generally required to register with the SEC and (ii) states may not require licensing of SEC-registered advisers (i.e., California and other states can require licensing of investment advisers not registered with the SEC). The Commissioner believes that GPs of VCCs in excess of \$25 million would, if subject to licensing as an investment in California, elect instead to register as an investment adviser with the SEC.

AUTHORITY

Section 25204 and 25610, Corporations Code.

REFERENCE

Section 25230, Corporations Code.

AVAILABILITY OF MODIFIED TEXT

The text of any modified regulation, unless the modification is only non-substantial or solely grammatical in nature, will be made available to the public at least 15 days prior to the date the Department adopts the regulation(s). A request for a copy of any modified regulation(s) should be addressed to the contact person designated below. The Commissioner will accept written comments on the modified regulation(s) for 15 days after the date on which they are made available. The Commissioner may thereafter adopt, amend or repeal the foregoing proposal substantially as set forth above without further notice.

AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS/INTERNET ACCESS

The express terms of the proposed action may be obtained upon request from any office of the Department. Request Document OP 07/99-B. An initial statement of reasons for the proposed action containing all the information upon which the proposal is based is available from the contact person designated below. Request Document OP 07/99-C. These documents are also available at the

Department's website www.corp.ca.gov. As required by the Administrative Procedure Act, the Office of Policy maintains the rulemaking file. The rulemaking file is available for public inspection at the Department of Corporations, Office of Policy, 1515 K Street, Suite 200, Sacramento, California.

AVAILABILITY OF THE FINAL STATEMENT OF REASONS

Upon its completion, the Final Statement of Reasons will be available and copies may be requested from the contact person named in this notice or may be accessed on the website listed above.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code section 11346.5, subdivision (a)(13), the Department must determine that no reasonable alternative it considered or that has otherwise been identified and brought to the attention of the Department would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed action.

FISCAL IMPACTS

- Cost Savings to any State Agency: None.
- Direct or Indirect Costs or Savings in Federal Funding to the State: None.
- Other nondiscretionary costs/savings imposed upon local agencies: None

DETERMINATIONS

- The Commissioner has made an initial determination that the proposed regulatory action:
- Does not have an effect on housing costs.
 - Significant statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states: None.
 - Investment advisers are not considered a small business under Government Code Section 11342.610.
 - Does not impose a mandate on any local agency or school district or a mandate that is required to be reimbursed pursuant to Part 7 (commencing with Section 17500) of Division 4 of the Government Code.

- Does not significantly affect (1) the creation or elimination of jobs within the State of California; (2) the creation of new businesses or the elimination of existing businesses within the State of California; (3) the expansion of businesses currently doing business within the State of California.
- Cost impacts on representative private person or business: The Department of Corporations is not aware of any cost impacts that a representative person or business would necessarily incur in reasonable compliance with the proposed action.

CONTACT PERSON

Nonsubstantive inquiries concerning this action, such as requests for copies of the text of the proposed regulations, may be directed to Kathy Womack at (916) 322-3553. The backup contact person is Karen Fong, (916) 322-3553. Inquiries regarding the substance of the proposed regulation may be directed to William Kenefick, Acting Chief Deputy Commissioner, Department of Corporations, 1515 K Street, Suite 200, Sacramento, California 95814-4052. (916) 322-3553.

Dated: March 5, 2001
Sacramento, California

WILLIAM KENEFICK
Acting Chief Deputy Commissioner